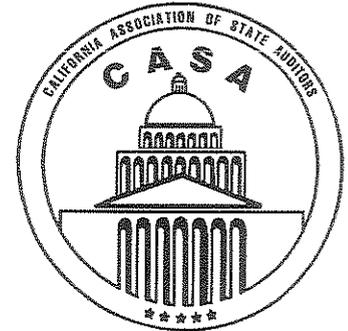


# CALIFORNIA ASSOCIATION OF STATE AUDITORS

## **CASA Officers**

President: Richard B. Smith  
Vice-President: Roberto Zavala  
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August 29, 2007

Diana L. Ducay, Chief  
Office of State Audits and Evaluations  
Department of Finance  
300 Capitol Mall, 8<sup>th</sup> Floor  
Sacramento, CA 95814

Dear Ms. Ducay:

We have completed an external quality assurance review of the Department of Finance (DOF) Office of State Audits and Evaluations (OSAE) for audits and reviews completed July 1, 2003 through June 30, 2006. We have issued a separate letter presenting our opinion that OSAE was in compliance with the Government Auditing Standards (GAO or Yellow Book) during the period reviewed. We found that OSAE has sound internal and quality control systems in place to appropriately manage and conduct its activities. However, we identified areas where the OSAE could further strengthen its procedures and implement best practices. This letter should be read in conjunction with our opinion report.

To assess compliance with the standards, we followed the standards and guidelines contained in the CASA Peer Review Guide published by the California Association of State Auditors (CASA). CASA has adopted the Association of Local Government Auditors Quality Control Review Guide and adapted it with input from the Texas State Agency Internal Audit Forum to ensure that the Peer Review meets the needs of agencies under both the GAS or Yellow Book and the Institute of Internal Auditors (IIA) Professional Practices Framework (Red Book). We examined OSAE's overall quality control system and reviewed the support documentation for audits/follow-up reviews conducted during the period July 1, 2003 through June 30, 2006.

## Background

Since OSAE's last CASA Peer Review, GAS was revised in 2003, effective for audits completed after January 1, 2002. GAS has recently undergone another revision that is currently out as an exposure draft. Accordingly, this review was conducted under the 2003 revision.

We noted that in response to the last Peer Review, OSAE strengthened its controls and operations relative to documenting supervisory review and consistently prepared well-documented audit planning, audit programs, and working papers in most cases. In addition, the office now uses an auditor independence statement for each audit assignment. In addition, OSAE's controls and procedures for identifying training needs and monitoring and tracking continuing professional education (CPE) are quite strong. We would suggest continued diligence in determining which CPE courses apply as government related.

We identified some areas that OSAE's current policies and procedures did not address under the audit standards, as well as recurring instances of nonconformance with auditing standards in some of the audits we reviewed. The following is a discussion of the instances we identified and our recommendations for strengthening your internal quality control system.

#### Disclosure of Organizational Impairment

As discussed in the opinion report, DOF's lack of organizational independence led OSAE to recognize that it would not be independent under the GAS Standards (2003 Revision) effective for audit periods beginning on or after January 1, 2003 for audits of Executive Branch entities.

OSAE prepared an issue memo dated February 26, 2004, that addressed the Independence Standards under GAS and proposed various alternatives it could follow to mitigate the impairment. For engagements where GAS is cited (specific external audits and agreed-upon procedures engagements), OSAE recommended that it acknowledge the organizational impairment to potential clients and report the impairment in all audit reports, engagement letters, and interagency agreements, where required. OSAE audit and DOF executive management approved this policy on February 26, 2004. For engagements where the GAS Standards would not be cited, OSAE would not disclose the organizational impairment even though it existed.

For fiscal year 2003-04, we selected one agreed-upon procedures engagement where the audit plan and management letter issued on March 8, 2004 cited the GAS Standards. However, neither the management letter nor the statement of independence form signed by the auditors and OSAE management disclosed the organizational impairment. We also selected another applicable file from the same fiscal year and noted the engagement report did not disclose the organizational impairment.

#### **CRITERIA – General Standard 3.03, 3.27**

#### **Recommendation (1)**

We recommend that OSAE consistently follow its own policy and properly disclose its organizational impairment for engagements under the GAS Standards.

***OSAE Response** - We concur that OSAE should include the statement of independence in working papers and disclose its independence impairment in reports where applicable. The exceptions occurred during the initial implementation of OSAE's new statement of independence and disclosure policy. OSAE is now in full compliance with this policy.*

#### Planning

OSAE has established planning procedures to ensure its engagements are adequately planned in accordance with the Standards. The audit files generally contained audit planning documents, budgets, engagement letters, and entrance conference notes documenting the planning steps performed. However, we also noted several engagements wherein the auditors did not follow the established procedures.

One working paper file did not contain an engagement letter and planning document. Absent these documents, we could not determine whether the audit was properly planned in accordance with the standards. We noted that the client disputed the usefulness of the report format at the exit conference, and the final report was never issued. OSAE charged 16,055 audit hours on the assignment. If the client were billed at a standard rate of \$50/hour, the amount billed would have been over \$800,000 for a product that was never finalized.

We also noted that in one audit, OSAE staff did not follow-up on the client's concerns noted during the entrance conference. Specifically, the client expressed concerns over depreciation and excess incentive funds. This was documented in the working papers but was not followed-up during the audit. Instead, the documentation was crossed out without explanation.

We noted other instances where there was no written evidence that the supervisor approved a revision to increase budgeted hours on an engagement, and when the supervisor signed approval on the planning document a month after fieldwork was completed.

#### **CRITERIA – General and Fieldwork Standards 6.04, 6.10**

#### **Recommendation (2)**

OSAE should ensure that supervisors timely review audit planning, preliminary review, and scoping working papers prior to the time fieldwork is started. This will provide assurance that audits are adequately planned, scoped, and budgeted to meet audit objectives and other engagement requirements.

*OSAE Response - It is OSAE's practice to include engagement letters, planning documents, and follow-up of client concerns in the working papers, and to review and approve planning documents and budgets before fieldwork is started. OSAE will continue to enforce these requirements. Regarding the report that the peer reviewers indicated was never issued, after consultation the client requested OSAE to change certain aspects of the engagement approach and report format, and a report was subsequently issued.*

#### **Reporting – Timeliness**

OSAE prepares well-written audit reports that appropriately communicate audit results and conclusions, and provide recommendations when applicable. Based on our review of 43 audit files, two areas came to our attention that could benefit from improvements.

First, OSAE does not always issue its reports in a timely manner. On several occasions, draft reports were issued almost one year after the exit conferences were held with the clients. Furthermore, it was not uncommon for the final reports to be issued many months after the draft reports. The timeframes ranging from four months to nine months to issue the final report could be perceived as untimely. We were unable to determine the reasons for the delays because there was no written explanation in the working papers. In 3 of the 5 engagements reviewed for fiscal year 2003-04, the Supervisor reviewed the working papers two to six months after the auditor-in-charge submitted the working papers.

Supervisory review should be timely so that auditors can make revisions and corrections and not delay communicating the formal audit results. When the supervisory review is untimely, audit reports may be issued untimely as well.

In addition, OSAE could improve its report distribution process by documenting the appropriate officials to whom reports should be issued. During our review, we checked whether the engagement reports were distributed to officials interested in the results. We were unable to determine with a degree of certainty whether the reports were issued to all the appropriate officials because the working papers lacked documentation as to who should receive the reports. We believe OSAE could improve its process in this area by documenting conversations with the client for report distribution and using some type of report distribution checklist in the working papers.

#### CRITERIA – Reporting Standards 6.27, 6.49, 6.50

#### Recommendation (3)

OSAE should address the delays that are causing the untimely issuance of reports. The audit files should also document the reasons for the delays. Moreover, OSAE procedures should document and track the distribution of audit reports.

***OSAE Response** - We agree that in the past, working papers and reports were not always reviewed and issued timely. OSAE is working on operational changes that will address delays and improve the timeliness of reports. Regarding report distribution, we believe that the current transmittal process for identifying required report recipients meets the needs of OSAE's clients and any statutory recipients, for which OSAE has a standard distribution list.*

#### Working Paper Retention

On an annual basis, DOF completes several hundred audit and review engagements. For example, in fiscal year 2003-04, DOF performed 215 engagements: 61 Agreed Upon Procedures; 5 Compliance; 42 Financial Statements; 37 Grant; 4 Internal Controls; 47 Special Review; 6 Fiscal Compliance; 2 Quality Control; and 1 Risk Assessment. DOF also performed 565 Desk Reviews for the Office of Criminal Justice Planning. The DOF file room is not large enough to retain the working papers and files for the time period normally held by most audit organizations (three to five years from the audit issuance date). Consequently, DOF stores its working papers at the State Records Center (SRC) prior to the three-year threshold.

The Peer Reviewers initially requested 17 working paper files from the 2003-4 year. Of the 17, DOF staff was only able to secure 5 during the week the Peer Reviewers were on-site. Of the 12, 3 were archived and not available for review; 2 were desk reviews and audit reports that were returned to the responsible state agency; and 3 could not be located; The remaining 4 were not provided because DOF determined that standards were not cited so the engagements should not be included in the peer review sample population. Therefore, the reviewers selected 3 alternate working papers from that year and reviewed 8 files in total from the 2003-4 year. For the 2004-5 year, DOF was unable to locate 1 working paper file. With the exception of files not provided, because standards were not cited or were not reviewed by the Peer Reviewers due to time constraints, DOF was able to secure the 2004-5 and 2005-6 files requested.

We noted that audit working papers and permanent files are being stored in empty cubicles. DOF audit management informed us that this is where working papers are held when staff is using the working papers in order to perform an ongoing audit. Since staff does not have access to the file room, it is more feasible to temporarily store working papers in an area where it is accessible to staff. It did not appear that the empty cubicles being used were in close proximity to the staff; therefore, there is chance that working papers could be moved or disturbed without immediate detection. It would be more secure if staff had the working papers stored in their own working space or in close proximity to their cubicle. If records are unavailable or cannot be located, the audit organization is not meeting the audit standards related to audit documentation and audit evidence.

**CRITERIA – Field Work Standards 4.22 – 4.26, 7.66 – 7.71**

**Recommendation (4)**

We recommend that DOF management attempt to secure additional file storage space that is secure in a location where it can be accessed by appropriate DOF staff.

***OSAE Response** - It is OSAE's practice to secure working papers not required for current assignments or those containing confidential information in locked storage areas within OSAE. These storage areas are sufficient for OSAE's needs. Regarding the fiscal year 2003-04 files that could not be located, OSAE will take appropriate steps to ensure that selected files can be promptly retrieved on request.*

The attached document includes your complete response. We appreciate the opportunity to provide these comments to you and hope that you find them useful.



Richard B. Smith  
Assistant Executive Director  
California Horse Racing Board  
Team Leader

Attachment



July 20, 2007

Mr. Richard B. Smith, Assistant Executive Director  
California Horse Racing Board  
1010 Hurley Way, Suite 300  
Sacramento, CA 95825

Dear Mr. Smith:

### **Response to Peer Review Management Letter**

The Department of Finance, Office of State Audits and Evaluations (OSAE), submits its response to the management letter issued in conjunction with the external quality control review report.

As noted in the management letter, OSAE has well-documented audit planning, audit programs, and working papers, and strong controls and procedures for identifying training needs and tracking continuing professional education. The peer review included four suggestions to improve OSAE's operations and enhance compliance with *Generally Accepted Government Auditing Standards*. We offer the following comments to issues raised in the management letter:

#### Disclosure of Independence Impairment

We concur that OSAE should include the statement of independence in working papers and disclose its independence impairment in reports where applicable. The exceptions occurred during the initial implementation of OSAE's new statement of independence and disclosure policy. OSAE is now in full compliance with this policy.

#### Planning

It is OSAE's practice to include engagement letters, planning documents, and follow-up of client concerns in the working papers, and to review and approve planning documents and budgets before fieldwork is started. OSAE will continue to enforce these requirements. Regarding the report that the peer reviewers indicated was never issued, after consultation the client requested OSAE to change certain aspects of the engagement approach and report format, and a report was subsequently issued.

Mr. Richard B. Smith  
July 20, 2007  
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### Reporting

We agree that in the past, working papers and reports were not always reviewed and issued timely. OSAE is working on operational changes that will address delays and improve the timeliness of reports. Regarding report distribution, we believe that the current transmittal process for identifying required report recipients meets the needs of OSAE's clients and any statutory recipients, for which OSAE has a standard distribution list.

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It is OSAE's practice to secure working papers not required for current assignments or those containing confidential information in locked storage areas within OSAE. These storage areas are sufficient for OSAE's needs. Regarding the fiscal year 2003-04 files that could not be located, OSAE will take appropriate steps to ensure that selected files can be promptly retrieved on request.

We would like to thank the CASA review team for their professionalism and courtesy displayed during the review.

Sincerely,

*Original signed by:*

Diana L. Ducay, Chief  
Office of State Audits and Evaluations  
(916) 322-2985

cc: Mr. Roberto Zavala, President, California Association of State Auditors